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Current
Policy
No. 1223

# Challenges to the International Economy In the 1990s

United States Department of State
*Bureau of Public Affairs*
Washington, D.C.

*Following are remarks by Richard T. McCormack, Under Secretary of State for Economic Affairs, before the Conference on U.S. Perspectives, Washington, D.C., October 30, 1989.*

One of my colleagues at the State Department has suggested—perhaps in a fanciful mood—that we are at the "end of history," a time when the ideological struggle between communism and capitalism will cease with the final triumph of liberal democracy around the world. This is surely an overstatement, as anyone who has read Plato's timeless thesis on the frequently cyclic nature of government (from dictatorship, to oligarchy, to democracy, to anarchy, back to dictatorship) will readily appreciate. Nevertheless, we can scarcely ignore the accumulating evidence that the postwar period is indeed coming to an end.

As we look back on one era and look forward to a new one, there is much that we have to be thankful for, mainly, of course, that the debate between communism and capitalism did not require a catastrophic world war for resolution.

But as we stand here at this point in history, with free market economics in triumph, with an unprecedented period of global economic growth, and with world trade expanding last year at 10%, there is a general feeling of optimism, cautious optimism, as we look to the future. It is only cautious optimism, because any of us looking at the world picture can see some uncertainties that command our attention.

Today, I'm going to talk about three of these:

- How will Eastern Europe and the Soviet Union become integrated into the world economy?
- What have we learned from the international debt crisis?
- In what direction is the international trading system developing?

## Eastern Europe and the Soviet Union

As all of you here know, the winds of political and economic change are sweeping Eastern Europe and the Soviet Union. The basic thrust for this change comes from the desperate economic situation in these countries. The communist parties of these countries faced a terrible dilemma: Either accept the dislocations and uncertainties that major overhaul of the economy and political system would entail—or witness the gradual continued stagnation and decay that would otherwise proceed to the point that even maintaining strategic parity with the West would prove impossible. Their centrally planned and controlled economies simply do not provide enough to eat, the basic consumer necessities, or adequate housing. Communism as an economic experiment has failed because the incentives are all wrong. Innovation and hard work were, in fact, penalized by the very nature of the system. So its practitioners are turning to the West for inspiration and assistance. In short, they seek to become full players in the international economy.

We must ask not only how will they do it—indeed, if they do it—but what are the implications. The challenge of this daunting task—of moving from centrally planned to market-oriented economies—is unprecedented.

First, how will they do it? Economists can generally say what must be done: get prices right, control inflation and monetary expansion, create an independent central bank and bond markets, lower government deficits, stabilize exchange rates. With the help of the IMF [International Monetary Fund], countries can map out a strategy to get their macroeconomic houses in order, as Poland now is beginning to do.

What we know less about, however, is the process. What step should be taken first, then second? How does a country dismantle an interrelated web of control without causing economic and social chaos? If, for example, input prices are allowed to rise before the prices of outputs, potentially sound

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businesses could be driven into bankruptcy. How can a social safety net be created to support the population that the reforms are intended to benefit without undermining the reforms themselves?

It seems to many of us that what Poland, for example, needs—in addition to IMF and Western assistance—is an EC–1992 plan, a vision of its own. If Poland were to lay out a more detailed plan with a timetable for each step of the dismantling process, this could have a psychological and energizing effect. It would show the Polish people clearly where their government is leading them and when. They would be aware of the sacrifices but also the timing of potential benefits. As with the EC–1992 program, the excitement and visible progress of meeting goals feeds on itself and could instill the confidence needed to carry out difficult reforms. It could also serve as encouragement to foreign direct investment.

I returned a few days ago from an OECD [Organization of Economic Cooperation and Development] meeting in Paris where we were reviewing the results of *perestroika* in the U.S.S.R., and noting the fact that the minor reforms were often failing because the major reforms were not yet in place. One man observed that this sort of reform was like a country switching from a highway system where you drive on the left hand side of the highway to a system where you drive on the right side, except the changes were progressively made, starting one week with bicycles and later with cars and later still with trucks. Carnage is inevitable. That is why, I am sure, Mr. Sachs [Jeffrey Sachs, Harvard economist] is urging the Poles to do it all at once, so that the trucks don't crush the bicycles and thus discredit the experiment.

Second question: What does it mean to be part of the world economy? Now obviously, the economies of the East are already part of the global economic trading system, with important amounts of grain, oil, and other commodities trading hands between East and West. But what the Soviets clearly have in mind is full integration into the economic system of the West, including convertible currencies and membership in the Bretton Woods institutions. Poland and Hungary are already members of the World Bank, IMF and GATT [General Agreement on Tariffs and Trade]. It is highly questionable, however, whether the Soviet Union, with its much greater economic and political potential, could become a member of the Bretton Woods Institutions until it demonstrates real action—not just promises—on such things as a realistic exchange rate, greater privatization, broader movement toward market mechanisms, and an effective pricing system.

Beyond the economic tags we put on the discussion, what we really are also talking about is the adoption of a philosophy of nongovernment-controlled economies and people, indeed, governments and economies that operate on the principle of freedom. Obviously, the Soviet Union has a way to go to reach these objectives.

Third question: Do we know the implications of integration of East European economies with the world economy? Probably not, given the uncharted territory on which they—and China—have embarked. But we might consider the trade impact on some LDCs [less developed countries] that depend on barter trade with the planned economies. We also should consider the amount of Western financial support that this economic transition may require and the potential foreign policy fallout when this largesse does not—cannot—extend to all other needy countries. And will the reforms take hold before political or social upheavals occur? What steps, if any, can we in the West take to help prevent a Tiananmen Square incident and backsliding? And if this new breeze of freedom is turned off, what will we do?

The truth of the matter is that we in the West can only do a limited amount to help and influence this reform process. Ninety-five percent of the burden of making economic and political reform in Eastern Europe work will have to be done by the East Europeans themselves. We in the West can make a 5% contribution to the process with advice, education, limited assistance, and encouragement. In the case of the Soviet Union with its vastly larger economy and infinitely more complicated political situation, the West's contribution to success will be closer to 1%, with 99% on the shoulders of the Soviets themselves.

Is the transition going to be successful? No one knows. We can all see the formidable obstacles. The task of shifting from a command economy to a free market economy is a virtually uncharted path. There is going to be a lot of experimentation and tactical failure associated with this process. There will be inevitable reverses. But one mistake that we in the West should not make is to go from "europhoria" about the prospects to despair as the process takes longer than some had hoped. In this difficult undertaking what matters is not so much the timing, but that the process succeeds in the end. The West has a lot at stake in that success, including lower risks for war itself.

### The International Debt Crisis: What Have We Learned?

International borrowing and other capital flows can play a constructive, even vital, role in the international economy. At its best, international lending provides a powerful engine for growth. For example, European lending to the Americas in the 19th century helped to finance the railroad system—although the United States defaulted on some of these loans. More recently, international capital has been used to good effect by a number of economies such as South Korea and Taiwan. International lending can provide the financing that facilitates the necessary imports for growth and development.

Unfortunately, much of the lending of the 1970s did not fill this desirable role. It is true, of course, that excessive —some would say even "addictive"— borrowing initially provided the means to accelerate growth. But this has been more than outweighed by the debt hangover of the 1980s, when the international debt crisis has contributed to economic stagnation in a number of countries.

For this sorry outcome, governments in both borrowing and lending countries share responsibilities. Too often, too little attention was paid to ensuring that the loans would be used to enhance productive capacities. Here, it seems to me, the international lending institutions have a better track record than national governments. Tying loans to specific productive projects provides a useful discipline. So does conditionality. The IMF clearly is in a better position to impose and follow through on conditions than is an outsider national government such as ours.

Private commercial bankers also share the responsibility for the debt crisis. In the 1970s, some banks were carried away by the prospects of easy profits and paid too little attention to the risks. Now we have the opposite problem. New money flows have largely dried up. Banks clearly must make their own decisions on these matter, but

the question may at least be raised whether the banks are now too mindful of the risks. They may, in some cases, be overlooking the opportunities for new business in Latin America and other developing countries.

Let me take only the case of Brazil, which I observed closely as OAS [Organization of American States] Ambassador for nearly 4 years. From 1945-80, Brazil enjoyed compound annual growth rates approaching 10% a year. That was a phenomenal record which demonstrated a high degree of national talent and purposefulness. If you take a look at many of the indices of Brazilian society and its economy, you will find many similarities to the United States of 1900 as the United States was edging closer to the forefront of nations.

Let's not forget that we, too, had our panics, our depressions, our periods of misrule, large-scale defaults on loans, and at one point even a grotesquely wasteful civil war. But we emerged a strong, confident, and wealthy nation.

It would be a grave mistake to consider Brazil's current period of self-doubt and stagnation as a permanent condition, or even one which is likely to continue for a significant period. The same is true for a number of other countries in the region.

The great misfortune of the Latin American region has been a fatal attraction for a heavy state intervention in the economy, with all the attendant problems associated with this phenomenon. Macroeconomic errors compounded the problem.

But all over the world, governments and societies are struggling to reduce the state sector in economies to liberate the individual energies of the people. Anyone who thinks that Latin America will be immune to the impact of this global intellectual and economic revolution is dead wrong. And once the heavy hand of the state is lifted from these economies, and once sound macroeconomic policies emerge, you are going to see a new burst of economic growth that will impress you, assuming, of course, that the rest of the world trading system remains healthy and open.

Latin America is extremely important to the United States both strategically and as a market. Writing the region off now would be a foolish and self-defeating mistake. Look how fast East Asia came into its own once it got its policies right. Brazil, for example, is likely to emerge gradually as a world power in the course of the next half century.

### Whither the International Trading System?

A major challenge we face today in international trade is to determine what kind of international trading system we want. Since World War II, the United States has consistently worked for a more open multilateral trading system.

We recognized that in a sense the tensions that had led to two World Wars had many of their ultimate roots in the scramble of manufacturing nations to secure markets and raw materials. This nation's commitment to the principles of freer trade was, in part, a desire to remove the incentives for war.

Fundamental to this approach has been the role of the GATT, which has spurred global economic growth through several rounds of tariff cuts. But like all institutions, GATT must change with the times.

This is precisely what the current GATT Uruguay Round of multilateral trade talks is intended to do—update the GATT system to more closely reflect today's trade realities. GATT has succeeded in significantly lowering tariff barriers and has begun to chip away at nontariff barriers. But there are important areas that either are inadequately covered or not covered at all by GATT trading rules—agriculture, services trade, intellectual property, and trade-related investment measures. Over $1 trillion in goods and services trade is not covered by GATT rules. Beyond that, we have the pernicious phenomenon of de facto managed trade within the GATT rules themselves, violating the spirit, though not the letter, of the GATT. Examples abound. They range from voluntary restraint agreements to the complicated impediments to imports of various kinds that exist in Japan and various other important, major new participants in the global trading system.

The Uruguay Round is the most ambitious multilateral negotiation yet undertaken—over 100 nations are participating to hammer out agreements in 17 areas of trade barriers. We are scheduled to conclude the Uruguay Round next year, December 1990.

The United States has made it clear that negotiators must adopt fundamental reforms—especially in agricultural trade—for the round to succeed. We must not forget that the ambitious agenda for the Uruguay Round was born out of a general fear of a new wave of protectionism. An empty subsequent agreement that does not meaningfully address the fundamental problems outlined at Punta del Este, Uruguay, would be a major disappointment and could add fuel to the very fire that the round itself was designed to quench. Some very tough bargaining lies before us in the year ahead.

Another challenge to the trading system is the stubbornly wide payments imbalances between countries, imbalances that pose increasing dangers if not corrected. I am speaking particularly, of course, of the U.S. trade deficit and the trade surpluses of Japan, West Germany, and certain others. Those imbalances were described at the Paris economic summit as unsustainable. And indeed they are.

In one of his final speeches as Secretary of State, George Shultz pointed out that the United States could not indefinitely run trade deficits and that ultimately the United States would have to run a trade surplus—a large trade surplus—to pay off the indebtedness which we have run up, the cost of essential imports, and the repatriated profits that will flow from foreign investment here.

This obvious but central fact has not really sunk in either domestically or internationally. Who wants to think about chilly weather during a glorious Indian summer?

To accomplish what will be required of us, we as a nation will have to save more, spend less, invest more, pour more resources and imagination into a modernized educational process and into research and development. We will also have to improve on one shortcoming that is pointed out to us by our Japanese friends, namely, our ability to turn our many technological breakthroughs into world class products ahead of the competition.

That's the part we will have to do domestically. At the same time, we are going to have to continue a major sustained effort to open up to a greater degree the domestic markets in Japan and other surplus countries, something very much in the mind of our colleagues at USTR [U.S. Trade Representative] and elsewhere in the executive branch. We are hoping that the structural impediments talks with the Japanese will also make a contribution to this effort over time.

Japan is frequently cited by American trade experts, not because there are not problems elsewhere, but because there is an imbedded trade deficit exceeding $50 billion a year that has, thus far, been immune to our currency realignment measures and other efforts to be more competitive.

Trade practices, which were not unduly unsettling during the immediate postwar period when we were helping Japan to get back on its feet, become far less acceptable when they involve what is now one of the largest economies in the world.

What troubles us? Such things as a percentage of U.S. exports to Japan of semiconductors which remains fixed at about 10% of market share regardless of the relative state of the dollar and the yen and regardless of the condition of the economy. It is clearly a managed percentage. And it is not an isolated example.

The patent system of Japan is also troubling to us, as it operates in such a way as to limit the ability of overseas and, indeed, Japanese investors to protect and market their inventions. Corning Glass' difficulties with its fiber optics technology is a case in point.

Petty harassment of imports is another impediment, including such things as the individual inspection of roses at customs, which does not exactly encourage the large-scale import of flowers. This latter obviously affects the exports of Colombia more than the United States, but it is symptomatic of a broader problem. The customs system is simply not geared for the efficient processing of many imports.

An antiquated, small-scale distribution system tied to local manufacturers and bid-rigging on an impress-ive scale are additional problems that we are trying to address in the structural impediments talks.

Now, at this point, I would add that many of these problems are very familiar to me as a historian, because they are broadly reminiscent of past U.S. trade and economic practices which go back to the 1920s in some cases.

In fact, if you look a bit, you will find many parallels between Japan of today, and the United States of the 1920s. Both were newly emerging economic giants with limited national consciousness of their real role and responsibilities in the world economy. Both emerged during major international debt crises, the United States during the post-World War I debt crisis; Japan during the more recent one.

The trading policies of both countries were driven by mercantile considerations; both were governed by center right parties; both were characterized by a certain amount of highly speculative economic activity. We had our Florida land boom (and bust); Japan of today has seen land prices rise to stratospheric heights, to the point that the tiny island in Tokyo upon which the Emperor has his palace and grounds is worth more than half the state of California.

Fortunately, the world has learned a great deal since 1929, so I would expect the parallels to end differently. But when I read last Thursday in the lead item of the Wall Street Journal about Japan's massive current capital expansion plans, even in those industries where there is existing overcapacity, I know that all involved will want to beware of the problem identified by Kondratief more than a half a century ago, namely the potential for overcapacity in production to impact upon sustained economic growth.

If I were a Japanese planner at this point, I would be thinking a bit more about the need for greater public investment in Japan, more and better highways, better housing for the people, and a better deal for the consumers of the nation.

As I stated clearly at the outset, I am optimistic as I look to the future. We have made substantial progress on our trade and budget deficits, our autos and many other products are far superior to those we were producing a decade ago. We have won the world battle for free market economies and that inevitably means greater prosperty for more people, including customers for U.S. exports in the years ahead.

The only things we have to do to ensure that this beautiful and productive garden continues to bloom and produce are to remove the weeds on a timely basis and make sure that enough fertilizer is added periodically.

It is a fascinating time to be involved with international economics, and it has been my pleasure to have been with you this morning. ■

Published by the United States Department of State • Bureau of Public Affairs • Office of Public Communication • Editorial Division Washington, D.C. • November 1989
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